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Ensure VCs don't drag you out of your venture

Starting Up takes you behind scenes with the legal modalities of a term-sheet deal and gives you the dos and the don'ts while bringing on board a venture capitalist

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TO MOSTpeople 'drag along' probably means nothing more than just another English phrase. But for an entrepreneur signing a term sheet few things could be more devastating than this simple phrase. Simply put, the 'drag along' clause is one of the most dreaded clauses in a term sheet. It is considered to be draconian because it can quite simply force an entrepreneur out of the venture he has built. This clause is structured in a manner such that when the investor — a VC or a PE — decides to sell his stake to a third party, the entrepreneur is 'dragged along' and forced to sell his stake as well. It may sound unfair, but industry watchers say is a fairly common practice. What makes it even trickier for young start-ups is the fact that this clause may not be stated upfront, but often can be slipped in by wording the document cleverly. And this is just one of many clauses in a term sheet that could do any start-up in.

Take another set of clauses that are popularly known as the 'ratchet clauses' or 'anti-dilution protection'. These clauses are used by VCs to protect their interests from a significant dilution. This is how it works. Let's say, for example, the majority shareholders of the company are your family members, and that in the past you've authorised certain issuances of common shares at low prices to them. To protect against dilution upon conversion of the preferred shares (or the convertible debentures), the venture capitalist may require that certain 'ratchet' provisions be built into the conversion terms of the preferred shares when you amend the company's corporate charter. These provisions will adjust the conversion price of the preferred shares to allow the venture capitalist to receive a greater number of common shares upon conversion than originally anticipated. Siddharth Shah, who heads Funds Practice Group at Nishith Desai Associates advises budding entrepreneurs to maintain level shareholding. "Entrepreneurs have to watch out for the anti-dilution clause. Also most investors tend to complicate the formulae prescribed in the ratchet clauses, and if one does not understand them, it effectively leads to dilution of an entrepreneur's stake in the company," he says.

Most start-ups are likely to get both, intimidated and confused, when faced with the legalese and fine print that makes up a term sheet. Given the pressure of trying to infuse funds into their venture many entrepreneurs end up signing documents, which they do not understand fully or have been explained by the buyers' lawyers. Says Kanwaljit Singh, MD, Helion Ventures, "Entrepreneurs need to ensure that all the major terms and conditions that affect the business and the investment needs are laid out upfront in the term-sheet. This allows for lesser conflicts at a later stage in the negotiations." He goes on to say that entrepreneurs have to invest the money and time to understand the wording in a term sheet before they sit down for a meeting with potential suitors.

It is not just the clauses that entrepreneurs need to study. They need to also be aware as to where the jurisdiction will take place in case there is a dispute. Foreign investors would prefer to have a home jurisdiction advantage. Says Aashish Bhinde, vice president, Avendus Advisors, "Venture capitalists who go in for offshore structuring believe that Indian courts take a long time to redress conflicts between investors and promoters. Therefore, most investors are looking for a jurisdiction outside India where the conflicts are redressed faster." While this might be convenient for VCs, entrepreneurs might find themselves done in by this. Says Daljit Titus, senior partner, Titus & Co Advocates, "Start-ups may not be able to afford expensive legal counsels in other countries. "

But it is not merely speed that propels VCs to invest through the offshore holding company route. Mr Titus believes it is also a smart way for VCs to limit their downside. He explains: "By having a Mauritius holding pattern, the investors end up insulating themselves with a limited liability. Also such a pattern helps them save on capital gains tax and royalty payments." These days most VCs prefer to have a holding company based in Mauritius, Bermuda or Singapore, where the Indian government has a 'no double taxation' treaty.

The term sheet also outlines procedures for redemption of preferred stock into common, the conversion schedules, provisions to guard against dilution of the investors' positions, voting rights and other "protective provisions" (to guard ownership-proportionate shares). Investors most often demand 'information rights' which is essentially a promise on the part of the start up to deliver unaudited quarterly financial statements and audited annual statements to inform investors of company activities. Industry experts issue a word of caution here. They believe that information rights are a less contentious issue. But they could have downside. Says Mr Titus, "Entrepreneurs need to be careful when they sign on the dotted line for information rights. Many a times, it may be that the investor if he is shopping around for similar companies might end up sharing the same with rival companies." It is always advisable therefore from an entrepreneur's point of view to sign up for information rights that deal with basic governance of the business, otherwise they may end up churning out unnecessary paperwork for the investors, he adds.

Having said that, entrepreneurs also need to keep an eye out for another pointer called 'material adverse effect clause'. Investors often use this clause to walk out if the market for the investee company turns unfavourable. Says Mr Shah, "Most contracts never end up defining the fine print of the material adverse effect." He says that it is imperative that the wording of the clause is such that it clearly defines the financial arrangement that would come into effect should this clause ever be invoked.

A part of the term sheet that most entrepreneurs pay little attention to is the clauses pertaining to liquidation. A sentiment that is understandable, given that most entrepreneurs are unlikely to think they will be folding up in the near future. However, this very complacency regarding 'liquidation rights' could lead to their undoing. In most cases, VCs will ask for preferred stock in the start-up, while founders and employees hold common stock. Preferred shareholders get paid off ahead of common stockholders during a liquidation or bankruptcy. Some VCs will also require that the entrepreneurs achieve certain milestones in order to earn that stock over time failing which founders begin forfeiting their take. Mr Bhinde believes the problem with this clause is that the VC has the best of both worlds. On one hand the entrepreneur has to bear the brunt if things go wrong because the VC is protected thanks to a limited downside. On the other hand if things are on track the VC reaps the same benefits as the entrepreneur.

The examples above are not exhaustive. The truth is that every term sheet is likely to have its own peculiarities. Be it determining levels of debt vs equity, minimum and maximum time periods associated with transfer of shares, vetoing IPOs, and having 'right of first refusal' when other rounds of funding are sought. The bottom line on term sheets is: Get everything stated clearly and definitively upfront so that the future is not fraught with uncertainty. The term sheet, remember, could becomes a great road map for funding your venture today and in the years to come.

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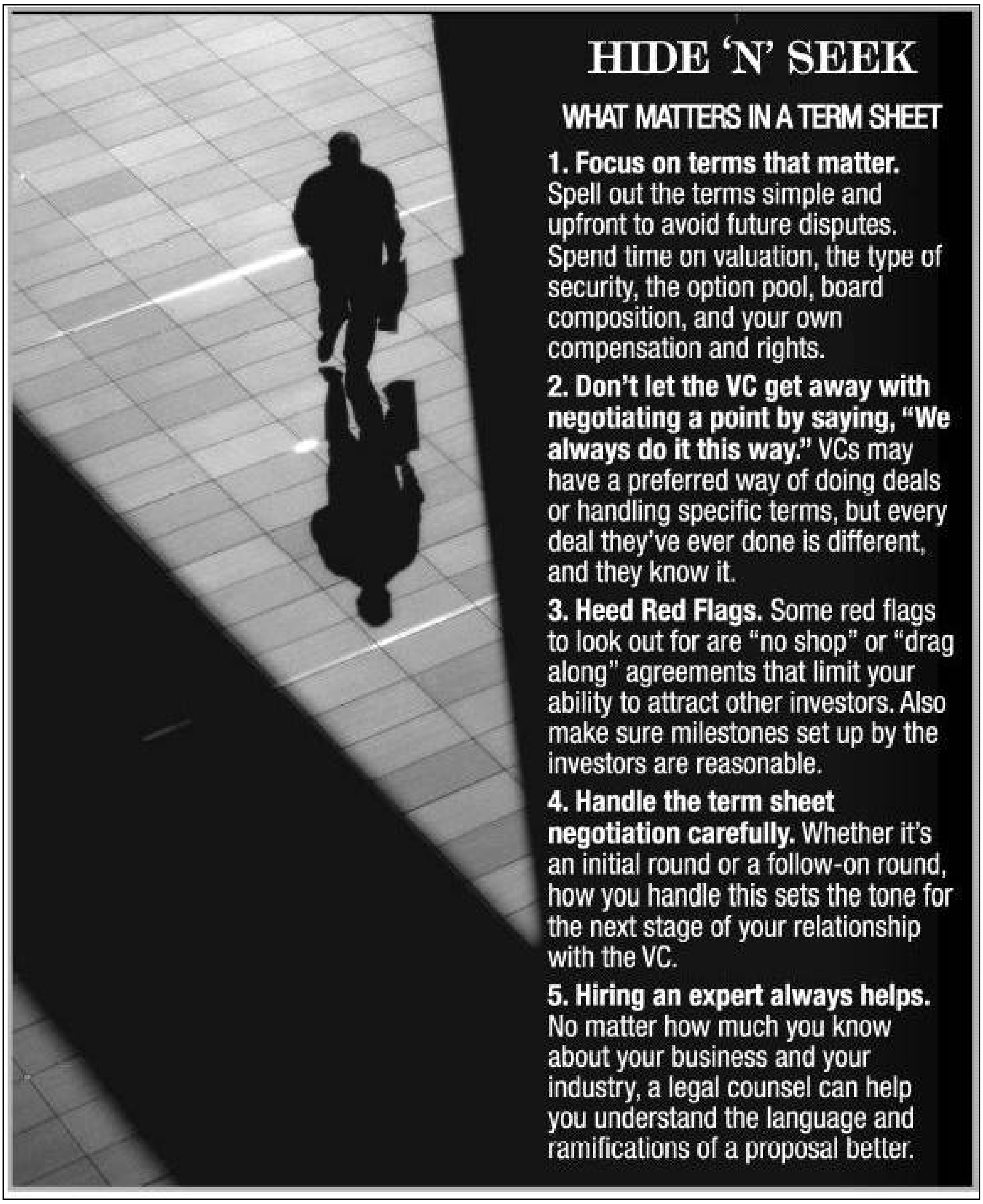

HIDE 'N' SEEK

WHAT MATTERS IN A TERM SHEET

1. Focus on terms that matter. Spell out the terms simple and upfront to avoid future disputes. Spend time on valuation, the type of security, the option pool, board composition, and your own compensation and rights.

2. Don't let the VC get away with negotiating a point by saying, "We always do it this way." VCs may have a preferred way of doing deals or handling specific terms, but every deal they've ever done is different, and they know it.

3. Heed Red Flags. Some red flags to look out for are "no shop" or "drag along" agreements that limit your ability to attract other investors. Also make sure milestones set up by the investors are reasonable.

4. Handle the term sheet negotiation carefully. Whether it's an initial round or a follow-on round, how you handle this sets the tone for the next stage of your relationship with the VC.

5. Hiring an expert always helps. No matter how much you know about your business and your industry, a legal counsel can help you understand the language and ramifications of a proposal better.